EUFederation
Factoring & Commercial Finance

To:
EBA
One Canada Square (Floor 46)
Canary Wharf
London E14 5AA
United Kingdom

Kraainem, 19th of June 2015

Ref: EBA Consultation on Guidelines on limits on exposures to shadow banking (EBA/CP/2015/06)

Dear Madam or Sir,

The EUF is the Representative Body for the Factoring and Commercial Finance Industry in the EU. and is composed of national and international associations for the factoring and commercial finance industry that are active in the EU. Its members represent over 97% of the industry turnover and include 14 national factoring and commercial finance associations (representing 15 EU-member states, namely [in alphabetic order] Austria, Belgium, the Czech Republic, Denmark, France, Germany, Greece, Ireland, Italy, the Netherlands, Poland, Portugal, Spain, Sweden and the UK) and two international factoring associations, who in turn represent 192 factoring and commercial finance companies. The EUF seeks to engage with governments and legislators to enhance the availability of finance to business, with a particular focus on the SME community. Furthermore, the EUF acts as a platform between the factoring and commercial finance industry, and key legislative decision makers across Europe, providing a source of reference and expertise on the factoring and commercial finance industry.

It is in this role that the EUF wishes to comment on the EBA's Consultative Document "Draft EBA Guidelines on limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Art. 395 para. 2 Regulation (EU) No. 575/2013" (hereafter: the Consultative Document). We would first like to refer you to the EUF's response to the EBA's Consultative Document on the Perimeter of Credit Institutions, dated 19 May 2015, since the EBA refers to its own Opinion and Report on this topic. In that position paper (cf. http://euf.eu.com/category/9-news-articles.html?download=279), the EUF explains where the differences lie between "traditional" bank lending/financing and factoring and why the two should therefore be treated differently.

Factoring and commercial finance (FCF) are generic terms for a range of asset based finance services which include factoring, invoice discounting, international factoring, supplier finance/reverse factoring and asset based lending. Due to differences between national laws, especially in civil or contract law, there are many variations on each of these product sets and the precise nomenclature varies from market to market, but all exist to provide working capital funding and financing solutions to businesses, particularly SMEs. These FCF services also have in common the idea that funding is offered based upon the accounts receivables created by the client company: With a factoring solution, the FCF company agrees to pay an agreed percentage of approved debts as soon as the receivables are assigned or (in some jurisdictions) pledged to it. If credit protection is part of the factoring agreement, it is referred to as “non-recourse” factoring, while a factoring agreement where the credit risk on the debtor remains with the seller is called “with-recourse” factoring. The factoring company will often also undertake all credit management and collections work. Factoring is therefore simply a unique blend of services designed to ease the traditional problems of selling on open account terms, mainly aimed towards SMEs.

According to the EBA’s Consultative Document (cf. p. 9), factoring companies are one example of entities “*carrying out credit intermediation*” and the EBA therefore considers them to be shadow banking entities, which due to potential risks could cause significant disruption to the wider financial system and economic activity at the global level. In the view of the EUF, the EBA’s general aim of preventing and managing certain prudential risks specific to the shadow banking sector is both comprehensible and laudable, but the arguments the EBA uses in this context are not generally applicable to the FCF industry. It is true (also and perhaps even particularly for factoring) that “*shadow banking can complement traditional banking by expanding valuable access to credit in support of economic activity … thereby supporting growth in the real economy*” (cf. p. 6 of the EBA’s Consultative Document). However, the arguments that “*previously unrecognised fault lines in the shadow banking system … put the stability of the financial system at risk*” and that “*increasing amounts of leverage*” were masked and that shadow banks are particularly vulnerable to runs and “*helped spread the stress to the traditional banking system*” (cf. p. 6 of the EBA’s Consultative Document) are neither applicable nor true for the factoring industry. On the contrary: Factoring helped alleviate the effects of the credit crunch when many banks could or would not finance especially SMEs, as shown by the increases in both factoring turnover and client figures also during the crisis.

The FCF industry has enjoyed a long history with a low record of credit losses and continuous and stable growth. Factoring is one of the very few sectors within financial services whereby a financial institution purchases the asset from the client, in this case the account receivables and all underlying rights, including the right of payment by the debtor. This strengthens the scenario that the factor will be paid. Traditionally, the receivables assigned to the factoring company are generally well diversified and of a short term duration (normally under a 90 day period). Also, the financing provided to the seller is contracted on a flexible basis, often providing leeway for the FCF company to exit quickly in a deteriorating financial condition scenario, which in part explains the low loss record for the FCF industry. Moreover, FCF companies use strong credit metrics, they benefit from their management of the receivables, enhanced credit underwriting analyses on both seller and buyer, a robust technology platform to manage the risk, along with a strategy of receivables diversification, keeping credit losses to a minimum.

In addition, the financial crisis did not occur due to a (assumed) complexity of the factoring industry, as the sector is not complex, but rather a true and straightforward reflection of the real economy. Only true sales between a seller and a buyer are financed, against a receivable, and financing by a factor does not exceed the amount of the receivable; on the other hand, there are limits in place to ensure the factor is only financing against an eligible receivable, net any dilution risk of the account. Factors are not engaged in OTC derivative contracts or similar activities. Neither are the global/cross-jurisdictional activities of the FCF industry a sign for its global systemic importance: In 2013, only approx. 15.5% of the total factoring turnover in the EU was attributed to international/cross border factoring. As for the indicator of interconnectedness with other financial institutions and markets, FCF companies are in this respect mainly interconnected to their refinancing partners which often are (parent) banks. Hence, this interconnectedness is already being considered in the assessment of (global systemically important) banks and should be excluded from being considered “shadow banking”.

In fact, when assessing the global systemic risk of FCF companies, it has to be taken into account that factoring and commercial finance has proven to be a real and frequently used alternative, but also an addition to the classic bank loan and has helped to alleviate much of the burden caused by the recent credit crunch, especially for SMEs. For example, in countries such as Germany and France, the number of factoring clients increased significantly from 2008 to 2009, i.e. during the worst time of the “credit crunch” (France: 28,800 clients in 2008 to 32,200 in 2009; Germany: 5,400 clients in 2008 to 8,840 clients in 2009). Also, the total factoring turnover in the EU decreased only very slightly from 2008 to 2009 (by -2,9%), only to increase again substantially in 2010 (by nearly +18% in comparison to 2009). This shows that the financial crisis did not affect the FCF industry negatively. Moreover, the fact that the FCF industry did not contribute to the causes of the recent financial crisis should not be overlooked: When compared with other forms of financing, which can be considered as contributing factors to the recent financial crisis, FCF is a low-risk form of financing, also thanks to its direct connection to the real economy via the purchase or transfer of receivables for delivered goods and rendered services.

The arguments put forward by the EBA in paragraphs 23 and 24 on p. 12 of the Consultative Document do not apply to factoring, which is a low-risk form of financing. Also, the flow of funds into factoring cannot be described as volatile as the factoring turnover is directly linked to the real economy’s turnover: If companies from the real economy cannot sell their products/services, then there are no receivables to use as basis for the financing provided by factoring companies. Also, the concerns about regulatory arbitrage contained in paragraph 25 on p. 12 of the Consultative Document, which are similar to the argument raised under option 3 on p. 31 of the Consultative Document, are not accurate: Regulatory arbitrage concerns generally refer to “traditional” credit institutions trying to “*migrate systemically away from the regulated sector ‘into the shadows’*”, i.e. that banks will try to e.g. establish subsidiaries or affiliates of some kind which are not subject to the same regulatory requirements as banks and may hence be part of what the EBA considers to be the shadow banking system. The EUF believes that requiring limits for exposures to shadow banking entities is not an adequate solution to the issue of regulatory arbitrage: While credit institutions financing/lending money to shadow banking entities would be covered by the exposure limit-guidelines, such re-financing is generally not based on regulatory arbitrage, whereas credit institutions holding some kind of share/equity interest in such shadow banking entities may be based on regulatory arbitrage. However, the latter would generally not be covered by the EBA’s exposure limit-guidelines because such entities would very probably be within the consolidation spheres of the credit institutions and hence outside the scope of application of the exposure limit-guidelines.

On pages 7/8 of the EBA’s Consultative Document, it is stated that shadow banking entities (and in turn factoring companies, according to the EBA’s definition) are vulnerable to runs. Again, this is not true for FCF: Factors are traditionally not deposit-taking institutions, but they rather provide finance to companies on a short term basis (less than 365 days). Neither are they taking on excessive leverage (factors only finance up to the value of the “eligible receivables balance” that has been assigned by the clients) nor does pro-cyclicality or opaqueness and complexity apply to the factoring industry. Factoring is a straightforward and quite simple form of financing based on receivables and hence directly linked to the real economy. It is true that some factoring companies (although not all) are highly correlated or interconnected with the regulated banking sector, but that is only one out of the four arguments stated by the EBA which applies to parts of the factoring industry, and moreover, this argument is sufficiently covered by the financial supervisory requirements which are applied on a consolidated group level as this correlation or interconnectedness often results from connections under company law (e.g. affiliates). Even the EBA says in its Consultative Document that when a shadow-banking entity such as a factoring company is part of a banking group, it should not fall within the scope of application of the limits on exposures to what the EBA considers as shadow banking entities, thereby effectively only including independent factoring companies in the scope of application of the draft guidelines on exposure limits and hence disadvantaging these independent factoring companies without any apparent or substantial reason.

On pages 8/9 of the Consultative Document, the EBA defines shadow banking entities in a very wide scope. In the opinion of the EUF, this definition is too wide. The EBA says that "*entities that are subject to an appropriate and sufficiently robust prudential framework*" are outside the scope of the definition of shadow banking entities, at least for the purposes of these exposure limit-guidelines. This is then at least partly reiterated with a slightly different wording in the draft guidelines on p. 18 of the Consultative Document: "*Excluded undertakings means … (3) undertakings … which are (e) financial institutions authorised and supervised by the competent authorities … and subject to prudential and supervisory requirements comparable to those applied to institutions in terms of robustness*". Moreover, on p. 29 of the Consultative Document, the EBA states that "*such a 'regulated framework' is understood as a robust prudential regulation framework where credit risk is adequately addressed*". All these varying descriptions of the same basic idea are nevertheless not 100% congruent, and they also either leave ample room for interpretation or even make such an interpretation necessary, thereby causing legal uncertainty not only for factoring companies.

In summary, we are of the opinion that the EBA must reconsider its definition of shadow banking before requiring any limits for exposures of credit institutions to shadow banking entities to be set. We do not believe that factoring should be included in the definition of shadow banking, for all of the aforementioned reasons, neither do we support the idea of limiting the exposures of credit institutions to (some or all) factoring companies. The FCF market is diverse, with over 500 factoring companies active in the EU member states. A large proportion, in some EU member states even a majority of these factoring companies are related to bank groups or owned by other regulated financial institutions. In the case of independent factoring companies, some (but not all) EU member states have implemented proportionate and factoring-specific regulatory oversight and rules. Hence, the limits for exposures of credit institutions to shadow banking entities as foreseen in the Consultative Document would not be applicable to all factoring companies, thereby distorting an already unlevel playing field even further, to the disadvantage of independent and mostly smaller factoring companies who are also financing the real economy, but were not in any way engaged in the activities that nearly brought down the financial markets in 2008/2009.

Below please find responses italicized to the specific questions outlined on page 33 of the EBA's draft guidelines report:

1. Do you agree with the approach the EBA has proposed for the purposes of defining shadow banking entities?

The EUF does not agree with this definition of shadow banking (entities). It is important to point out that factoring was part of the solution, not the cause for the problem to which the media generally referred to as the "credit crunch". Factoring helped alleviate the effects of the credit crunch, especially with regards to SMEs. The EBA's definition "shadow banking

entities" is very wide, if not even too wide, and in the context of the draft limit exposure guidelines, it is especially harsh on independent factoring companies which are neither credit institutions nor part of a consolidated banking group, thereby distorting competition even further and treating companies with comparable or even the same activities differently, although there is no well-founded argument to support this differentiation (this is also stated by the EBA, cf. p. 32).

- **Do you consider that this approach is workable in practice? If not, please explain why and present possible alternatives.**

The EUF believes that this approach is not workable in practice. The approach to defining shadow banking entities for the purpose of setting exposure limits is disadvantageous especially for factoring companies which are not part of a (consolidated) banking group and hence distorts competition even further and without need. Also, stating that "entities that are subject to an appropriate and sufficiently robust prudential framework" are outside the scope of the definition of shadow banking entities and similar descriptions/exemptions leave ample room for interpretation or even make such an interpretation necessary, thereby creating legal uncertainty not only for factoring companies. Moreover, on p. 22 of the Consultative Document, a number of practical implementation issues spring to mind when reading about what credit institutions should take into account when setting "tighter limits to their individual exposures to shadow banking entities" (cf. also question 4). How will the credit institution e.g. obtain information "about the portfolio of the shadow banking entity, in particular non-performing loans" and "about the adequacy of the credit analysis performed"? Such detailed information is generally not necessary in order to make an informed, prudential and risk-adequate decision on whether to re-finance a factoring company and should therefore not be required.

- **Do you agree with the proposed approach to the exclusion of certain undertakings, including the approach to the treatment of funds? In particular, do you see any risks stemming from the exclusion of non-MMF UCITS given the size of the industry?**

No comment. The EUF represents the factoring and commercial finance industry in the European Union, which is typically not engaged in MMF and similar activities.

- **If you do not agree with the proposed approach, please explain why not and present the rationale for the alternative approach(es) (e.g. on the basis of specific prudential requirements, redemption limits, maximum liquidity mismatch and leverage etc).**

See above

2. **Do you agree with the approach the EBA has proposed for the purposes of establishing effective processes and control mechanisms? If not, please explain why and present possible alternatives?**

Each credit institution already identifies its individual exposures to (what the Consultative Document refers to as) shadow banking entities as well as the corresponding risks and also manages these – this was already the objective and basis of the Basle II-framework and still holds true for Basle III/CRD IV/CRR. This risk management process also already includes

certain levels of interconnectedness (i.e. groups of clients), thereby sensibly and logically managing and minimizing concentration/correlation risks. However, creating a new "group of clients" and corresponding exposure limits which comprise so-called shadow banking entities purely because of their activities or because they belong to a certain industry does not seem logical, especially as these entities may be highly interconnected with credit institutions, but are not necessarily interconnected among each other. This argument also applies to questions 3 and 4.
Moreover, on p. 22 of the Consultative Document, a number of practical implementation issues spring to mind when reading about what credit institutions should take into account when setting "tighter limits to their individual exposures to shadow banking entities" (cf. also question 4). How are credit institutions e.g. supposed to establish whether a client is a shadow banking entity which falls within the scope of the EBA exposure limit-guidelines and how are they to determine the interconnectedness between these entities? How will the credit institution e.g. obtain information "about the portfolio of the shadow banking entity, in particular non-performing loans" and "about the adequacy of the credit analysis performed"? Such detailed information is generally not necessary in order to make an informed, prudential and risk-adequate decision on whether to re-finance a factoring company and should therefore not be required.
As a side note, the EUF wishes to point out the paragraph with the title "Reporting Requirements" on p. 16 of the Consultative Document: We read it to mean that all national supervisory authorities have to report to the EBA whether they will comply with these exposure limit-guidelines or not, but this reporting requirements seems quite superfluous considering that only a few paragraphs earlier, it is clearly stated that "the competent authorities and financial institutions must make every effort to comply with the guidelines".

3. **Do you agree with the approach the EBA has proposed for the purposes of establishing appropriate oversight arrangements? If not, please explain why and present possible alternatives.**

Please refer in part to the answer provided to question 2. The EUF believes that credit institutions' risk assessment and management should be proportionate and adequate. Considering not only the aforementioned arguments, but also the long-ranging positive development and strong health of the FCF industry, the EUF believes however that factoring companies should neither be included under the EBA's definition of shadow banking nor fall under the proposed exposure limit regime, but rather remain within the current risk management process. Moreover, in the context of the draft limit exposure guidelines, the EBA's wide definition of "shadow banking entities" is especially harsh on independent factoring companies which are neither credit institutions nor part of a consolidated banking group, thereby distorting competition even further and treating companies with comparable or even the same activities differently, although there is no well-founded argument to support this differentiation (this is also stated by the EBA, cf. p. 32).

4. **Do you agree with the approaches the EBA has proposed for the purposes of establishing aggregate and individual limits? If not, please explain why and present possible alternatives.**

Although these approaches reflect the proportionality principle to a certain extent, the EUF again refers to its criticism of the wide scope of the definition of shadow banking entities for

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the purpose of the proposed exposure limits (cf. our answer to question 1). Moreover, the requirements for credit institutions for setting "tighter limits to their individual exposures to shadow banking entities" which are set out on p. 22 of the Consultative Document entail practical implementation issues: How will the credit institution get hold of information "about the portfolio of the shadow banking entity, in particular non-performing loans" and "about the adequacy of the credit analysis performed"? Such detailed information is generally not necessary in order to make an informed, prudential and risk-adequate decision on whether to re-finance a factoring company and should therefore not be required. Rather, the regular risk management process already provides for risk adequate and proportionate decisions on a case-by-case basis.

5. **Do you agree with the fallback approach the EBA has proposed, including the cases in which it should apply? If not, please explain why and present possible alternatives. Do you think that Option 2 is preferable to Option 1 for the fallback approach? If so, why?**

The EUF wishes to point out that it seems that the EBA's choice (option 1) is based solely on the fact that this is the more conservative option/approach. Not only does this sound negatively biased towards the shadow banking industry as such (thereby including factoring, according to the EBA's definition), but it also fails to state why such a conservative approach is necessary in the first place in order to comply with CRR-requirements. The EUF cannot think of any reason why there should be a "punishment" for all exposures to shadow banking entities only because the credit institution in question cannot obtain sufficient information on e.g. one single exposure, which may also be comparatively insignificant. This is not in line with the proportionality principle and the qualitative financial supervisory approach.

6. **Taking into account, in particular, the fact that the 25% limit is consistent with the current limit in the large exposures framework, do you agree it is an adequate limit for the fallback approach? If not, why? What would the impact of such a limit be in the case of Option 1? And in the case of Option 2?**

Please also cf. our answer to question 2: Each credit institution already identifies its individual exposures to (what the Consultative Document considers as) shadow banking entities as well as the corresponding risks and also manages these – this was already the objective and basis of the Basle II-framework and still holds true for Basle III/CRD IV/CRR. This also already includes certain levels of interconnectedness (i.e. groups of clients), thereby sensibly and logically managing and minimizing concentration/correlation risks. However, creating a new "group of clients" and corresponding exposure limits which comprise so-called shadow banking entities purely because of their activities or because they belong to a certain industry seems neither sensible nor logical, especially as these entities may be highly interconnected with credit institutions, but are not necessarily interconnected among each other. Hence, setting an exposure limit to 25% on the basis of the current large exposures framework is a flawed argument: A group of connected clients is (as the name implies) connected, generally for reasons of control under company law (i.e. the client companies all belong to one corporate group so that there is an "infection risk": If e.g. a "mother company" becomes insolvent, it is very likely that its affiliates will also become insolvent or at least experience significant financial problems); shadow banking entities such as (according to the EBA's definition) factoring companies are generally not interconnected in this way, but they rather are competitors. If a factoring company experiences difficulties or even becomes insolvent, this

has so far not caused all other, "unrelated" factoring companies to experience difficulties or become insolvent, too.
Moreover, the EUF wishes to stress that shadow banking entities do not all belong to the same or even comparable industries – according to the EBA's definition, they range from e.g. factoring and leasing companies to securities and derivatives dealers and MMFs. Hence, this comparison invoked by the EBA creates a completely artificial group of clients, purely based on whether a company belongs to a certain industry, i.e. the shadow banking industry, which is an artificial concept, too. Following this line of thought to the very end, then it would only be logical to create groups of clients and corresponding exposure limits for each and every industry, e.g. based on the NACE-categories, which would be neither proportionate nor risk-adequate.

The EUF advocates that exposures of credit institutions to factoring companies should not be subject to stricter limits than exposures to companies from other industries, especially when and because these factoring companies are appropriately regulated and supervised, also in view of the proportionality principle.

Please do not hesitate to contact us should you have any queries regarding the aforementioned viewpoints or require more information on the factoring industry in Europe.

With kind regards,

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Chairman - EUF

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